

Aviation Information Management, Research and Special Programs Administration (RSPA)" and add "Office of Airline Information, Bureau of Transportation Statistics (BTS)" in its place.

57. In § 385.27(d), remove the term "RSPA" and add "BTS" in its place.

58. In § 385.27(i), remove the term "RSPA" and add "BTS" in its place, and remove the term Administrator, RSPA" and add "Director, BTS" in its place.

59. In § 385.27(m), remove the term "and with the policy set forth in § 399.100 of this chapter".

PART 399—STATEMENTS OF GENERAL POLICY

60. The authority citation for part 399 continues to read as follows:

Authority: 49 U.S.C. chapters 401, 411, 413, 415, 417, 419, 461.

§ 399.50 [Amended]

61. In § 399.50, remove the term "Board" and add "Bureau of Transportation Statistics" in its place, and remove the term "section 901(a) of the Act" and add "49 U.S.C. 46301" in its place.

§ 399.51 [Amended]

62. In § 399.51, remove the term "Board" and add "Bureau of Transportation Statistics" in its place.

§ 399.52 [Amended]

63. In § 399.52, remove the term "Board" and add "DOT" in its place.

§ 399.100 [Removed]

64. Section 399.100 is removed.

Issued in Washington, DC, on December 19, 1995.
T.R. Lakshmanan,
Director, Bureau of Transportation Statistics.
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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[T.D. 8642]

RIN 1545-AR48; 1545-AR93

Recognition of Gain or Loss by Contributing Partner on Distribution of Contributed Property or Other Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the recognition of

gain or loss on certain distributions of contributed property by a partnership under section 704(c)(1)(B) of the Internal Revenue Code of 1986 (Code). This document also contains final regulations relating to the recognition of gain on certain distributions to a contributing partner under section 737. The final regulations affect partnerships and their partners and are necessary to provide guidance for complying with the applicable tax law.

EFFECTIVE DATE: These regulations are effective for January 9, 1995.

FOR FURTHER INFORMATION CONTACT: Stephen J. Coleman, (202) 622- 3060 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The Revenue Reconciliation Act of 1989 added section 704(c)(1)(B) and section 704(c)(2) to the Internal Revenue Code. Section 704(c)(1)(B) provides that, in the case of a distribution of contributed property to another partner within five years of its contribution, the contributing partner must recognize gain or loss in an amount equal to the gain or loss the partner would have been allocated under section 704(c)(1)(A) on a sale of the property by the partnership at its fair market value at the time of the distribution. Section 704(c)(2) provides an exception for distributions of certain like-kind property.

The Energy Policy Act of 1992 added section 737 to the Code. Section 737 requires a partner who contributes appreciated property to recognize gain on a subsequent distribution of other property to the contributing partner to the extent of the lesser of (i) the net precontribution gain on property contributed by the partner, or (ii) the excess of the value of the distributed property over the adjusted basis of the partner's interest in the partnership.

On January 9, 1995, a notice of proposed rulemaking (PS-76-92; PS-51-93) under section 704(c)(1)(B) and section 737 was published in the Federal Register (60 FR 2352). Written comments responding to this notice were received. No public hearing was held because no hearing was requested. After consideration of all comments received, the proposed regulations under section 704(c)(1)(B) and section 737 are adopted as revised by this Treasury decision.

Summary of Significant Comments and Revisions

The significant comments on the proposed regulations and the revisions made in the final regulations are discussed below.

A. Section 704(c)(1)(B)

Determination of Gain and Loss

The proposed regulations provide that section 704(c)(1)(B) applies only to a distribution that is properly characterized as a distribution to a partner acting in the capacity of a partner within the meaning of section 731 and section 737, and not to a transaction or distribution that is subject to provisions other than section 731(a) or section 737. Comments requested that the provision be clarified. The final regulations clarify that section 704(c)(1)(B) applies only to the extent that a transaction is a distribution under section 731. References to transactions and distributions not subject to section 704(c)(1)(B) have been deleted.

One commentator suggested certain clarifying revisions to the proposed regulations' definition of fair market value. The definition in the proposed regulations, however, is identical to the definition of fair market value in the 704(b) regulations, and distributed property should have the same fair market value for purposes of determining gain and loss under section 704(c)(1)(B) and determining capital account adjustments under section 704(b). The final regulations therefore adopt the definition in the proposed regulations without change.

The proposed regulations provide that the amount of gain or loss resulting from a distribution of partnership property is determined as if the distributed property had been sold by the partnership to the distributee partner. As a result, if built-in loss property is distributed to a partner that holds more than a 50 percent interest in partnership capital or profits, the built-in loss that otherwise would be recognized is disallowed under section 707(b)(1)(A). One commentator suggested that section 704(c)(1)(B) was intended to address disguised sales between partners and that, therefore, a loss should be disallowed on a distribution only if it would be disallowed on a direct sale between the partners. Section 704(c)(1)(B), however, respects the form of the transaction as between the partnership and a partner and does not recast the transaction as a disguised sale. See H.R. Rep. No. 247, 101st Cong., 1st Sess. 406 (1989). The final regulations therefore adopt the proposed regulations without change.

Several of the provisions in the proposed regulations refer to distributions that are part of "the same plan or arrangement." Commentators requested clarification of this term. The reference to distributions that are part of the same plan or arrangement was

intended to reflect the fact that distributions of multiple properties to one partner or distributions of different properties to more than one partner over a period of time may be treated as part of the same distribution under general principles of taxation, such as the step transaction doctrine. The final regulations remove the reference to "same plan or arrangement" and refers to distributions that are part of the same distribution. This change is made for simplification only and is not intended as a substantive change to the scope of a distribution for tax purposes. As under current law, distributions do not need to be contemporaneous to be part of the same distribution.

Several comments were received regarding the effect of a partnership termination under section 708(b)(1)(B). One comment suggested that it was not clear whether property that had previously been contributed to the partnership (and was therefore already subject to a five-year period) was subject to a new five-year period after the termination. The final regulations clarify that a new five-year period does not begin to the extent of any pre-termination gain or loss that would have been allocated to a contributing partner under section 704(c)(1)(A) on a sale of contributed property immediately before the termination.

The legislative history of section 704(c)(1)(B) indicates that a constructive termination does not change the application of section 704(c) to pre-contribution gain or loss on property contributed to the partnership before termination. One comment read this legislative history as possibly suggesting that a pro rata distribution is deemed to occur under section 708(b)(1)(B) for section 704(c)(1)(A) purposes, but a different distribution is deemed to occur for section 704(c)(1)(B) purposes. The comment expressed concern about the complexity of such a system. Section 704(c)(1)(B), however, does not require or impose such a "hybrid system." The amount of gain or loss under section 704(c)(1)(B) is determined by reference to the amount of gain or loss that would have been allocated to the partner under section 704(c)(1)(A) if the property had been sold. Thus, property of a partnership that terminates under section 708(b)(1)(B) is deemed to be distributed to the partners in the same manner for both sections.

Another comment suggested it was unclear whether section 704(c)(1)(B) could apply to property that had not been contributed by a partner to the partnership prior to the termination. The final regulations confirm that a new five-year period begins for all property

that is deemed contributed to the new partnership after the termination (which would include property not actually contributed to the partnership), except to the extent that such built-in gain or loss would have been allocated to the contributing partner under section 704(c)(1)(A) on a sale of the contributed property immediately before the termination.

Commentators also requested guidance on the interaction of section 708(b)(1)(B) and section 704(c) in general. The IRS and Treasury recognize the need for additional guidance on this issue, but such guidance is beyond the scope of these regulations. The IRS and Treasury are considering a separate project involving the interaction of section 704(c) and section 708(b)(1)(B) and invite additional comments and suggestions regarding the project.

Exceptions

The proposed regulations provide that section 704(c)(1)(B) does not apply to property contributed to the partnership on or before October 3, 1989. One commentator requested an exception for property required to be contributed under a binding contract entered into on or before October 3, 1989. The statutory effective date provisions, however, do not contain a binding contract exception. Accordingly, the final regulations adopt the proposed regulations without change.

One commentator suggested an additional exception for distributions of an undivided interest in property. The final regulations provide that section 704(c)(1)(B) does not apply to such a distribution to the extent that the distributed interest does not exceed the undivided interest contributed by the distributee partner.

One commentator also requested an additional exception for distributions of fungible property because the partners may not be able to track the specific contributed property. The final regulations do not provide such an exception. Contributed property may be fungible from an economic perspective, but such property is generally not fungible for tax purposes because each contributed property will have its own individual tax basis.

The proposed regulations provide an exception for distributions of section 704(c) property to a noncontributing partner in liquidation of the partnership if the contributing partner receives an interest in the contributed property and the built-in gain or loss in that property is equal to or greater than the built-in gain or loss that would have otherwise been allocated to the contributing partner. One commentator suggested

that the exception more clearly indicate the amount of built-in gain or loss that must be reflected in the property distributed to the contributing partner. The final regulations clarify that the amount of the built-in gain or loss must be equal to the gain or loss that would have been allocated to the contributing partner under section 704(c)(1)(A) if the contributed property had been sold immediately before the distribution.

One commentator also suggested expanding this exception to apply to the extent of the built-in gain or loss in the property distributed to the contributing partner. This comment is not adopted in the final regulations. The exception was intended to apply only in the limited situation in which a partnership liquidates and the value of the contributed property exceeds the contributing partner's capital account. In that situation, the portion of the contributed property in excess of the contributing partner's capital account would have to be distributed to another partner, thereby triggering section 704(c)(1)(B). The exception allows a partner to avoid section 704(c)(1)(B) in this situation, so long as the built-in gain or loss in the property distributed to the contributing partner is at least equal to the gain or loss that would have been allocated to the contributing partner under section 704(c)(1)(A) if the contributed property had been sold immediately before the distribution.

Special Rules

The proposed regulations provide a special rule under section 704(c)(2) for situations in which the partnership distributes like-kind property to a contributing partner within a specified period of the distribution of the property contributed by that partner. Under this rule, the gain or loss that otherwise would have been recognized on the distribution of the contributed property is reduced by the amount of the contributing partner's built-in gain or loss in the distributed like-kind property. One commentator criticized this rule as inconsistent with the statutory provision.

Section 704(c)(2) provides that "[u]nder regulations prescribed by the Secretary, * * * to the extent of the value of the [like-kind property distributed to the contributing partner, the calculation of the contributing partner's gain or loss attributable to the distribution of the contributed property] shall be [determined] as if the contributing partner had contributed to the partnership the [like-kind] property." This provision is generally intended to treat the contributing partner as if the partner had exchanged

the contributed property for like-kind property in a nontaxable exchange outside of the partnership. This allows the contributing partner to avoid recognition of gain or loss under section 704(c)(1)(B) on the distribution of the contributed property to another partner because the contributing partner is treated as having contributed the like-kind property, not the property that is actually distributed to the other partner.

If the contributing partner, however, had engaged in a like-kind exchange outside of the partnership, the partner's built-in gain or loss in the like-kind property received would have been the same as the property that was surrendered. The rule in the proposed regulations reflects this result by limiting the application of section 704(c)(2) to the extent that the built-in gain or loss in the contributed property is not preserved in the like-kind property distributed to the contributing partner. The IRS and Treasury continue to believe that the regulations properly implement Congress' objective with respect to this provision. Therefore, the regulations are finalized without change.

One commentator also suggested a clarification of the interaction of the like-kind exception and the disguised sale rules of 707(a)(2)(B). The proposed regulations provide that the like-kind exception reduces any gain that would have otherwise been recognized under section 704(c)(1)(B). The proposed regulations also provide that section 704(c)(1)(B) applies only to a distribution to a partner within the meaning of section 731. There is no suggestion in section 704(c)(2) or the proposed regulations that the like-kind exception was intended as an exception to the disguised sale provisions. The final regulations confirm that the disguised sale provisions can apply to a distribution, even if the distribution would otherwise have qualified for the section 704(c)(2) like-kind exception.

Anti-Abuse Rule

Commentators made several suggestions for clarifying or modifying the anti-abuse rule in the proposed regulations. In particular, these commentators requested clarification of the relationship between this rule and the general partnership anti-abuse rule in Treas. Reg. section 1.701-2. The general anti-abuse regulation is a rule of general applicability that provides general principles to be applied in interpreting and applying all of the provisions of subchapter K. In certain situations, however, more specific anti-abuse rules are needed to carry out the purpose of a particular provision. The

final regulations therefore adopt the rule in the proposed regulations without modification.

B. Section 737

Determination of Gain

The final regulations are clarified to provide that section 737 applies only to the extent that a transaction is a distribution under section 731. In accordance with section 737(d)(2), the final regulations also provide that section 737 does not apply to the extent that section 751(b) applies to the distribution.

Net Precontribution Gain

The proposed regulations provide that a distributee partner's net precontribution gain is determined without regard to the like-kind exception of section 704(c)(2) in situations in which the contributed property is not actually distributed to another partner. One commentator suggested deleting this provision as superfluous. The final regulations adopt the proposed regulations without change. This provision clarifies that section 737 does not contain a like-kind exception similar to the exception in section 704(c)(2). Section 737 applies even if the property received by the partner is of a like-kind with the contributed property.

Character of Gain

One commentator suggested that the proposed regulations fail to clarify whether there are two groups (ordinary and capital) for purposes of determining the character of a partner's net precontribution gain or whether there may be an additional section 1231 group or section 1245 and section 1250 groups. The final regulations adopt the proposed regulations without change.

The proposed regulations provide that character for purposes of a partner's net precontribution gain is determined as if the contributed property were sold to an unrelated third party. As a result, all of the provisions that are relevant in determining the character of gain or loss on a sale are relevant in determining the character of the net precontribution gain. For example, if the sale of property would have resulted in part capital gain and part ordinary income, the character of the net precontribution gain for that property is part ordinary and part capital. The same approach applies in determining the allocation of any adjustment to the partnership's basis in partnership property as a result of gain recognized by the distributee partner. A basis adjustment attributable to gain treated as capital gain under section

1231 would be allocated to the property that entered into the calculation of the amount of section 1231 gain.

One commentator also suggested that the proposed regulations do not clarify whether character is determined at the partnership or the partner level. This determination may be important in situations such as section 1231 where the character of the gain or loss may depend on the partner's particular tax circumstances. The final regulations clarify that the character of the gain or loss is determined at the partnership level for this purpose.

Exceptions

One commentator suggested adding an exception for certain divisive transactions in which the contributing partner continued to own an indirect interest in the contributed property. The final regulations add a new exception under which section 737 does not apply to a transfer of contributed property by a transferor partnership to a transferee partnership, followed by a distribution of an interest in the transferee partnership (and no other property) to the contributing partner in complete liquidation of the partner's interest.

This exception is added because the distributee partner has simply converted an interest in the transferor partnership into an interest in a transferee partnership that holds the same contributed section 704(c) property. The limitations on this exception ensure that the partner's basis in the transferee partnership attributable to the contributed property is the same as the partner's basis in the transferor partnership attributable to that property. This allows a partnership to engage in a divisive split-up transaction, while preventing any avoidance of section 737 that might occur as a result of the basis allocation rules for non-liquidating distributions.

The proposed regulations provide that section 737 does not apply to an incorporation of a partnership other than an incorporation involving an actual distribution of partnership property to the partners. One commentator suggested that this distinction between methods of incorporation creates an unnecessary trap for the unwary and may have a chilling effect on the conversion of partnerships into S corporations. The final regulations adopt the proposed regulations without change. The form of incorporation chosen by the partners is respected for Federal tax purposes and, as a result, the distribution of property in connection with the incorporation is treated as a distribution for purposes of section 737.

One commentator suggested an additional exception for distributions of an undivided interest in property similar to that described with respect to the regulations under section 704(c)(1)(B). The final regulations provide a comparable rule under section 737.

Anti-Abuse Rule

Commentators made several suggestions regarding the anti-abuse rule in the proposed regulations. These suggestions are essentially the same as the comments regarding the anti-abuse rule in the section 704(c)(1)(B) regulations, and thus the comments are discussed above.

Effective Date

These regulations are effective for distributions by a partnership to a partner on or after January 9, 1995.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

Several persons from the Office of Chief Counsel and the Treasury Department participated in the development of these regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805 * * *

Section 1.704-4 also issued under 26 U.S.C. 704(c) * * *

Par. 2. Section 1.704-4 is added to read as follows:

§ 1.704-4 Distribution of contributed property.

(a) *Determination of gain and loss—*
(1) *In general.* A partner that contributes section 704(c) property to a partnership must recognize gain or loss under section 704(c)(1)(B) and this section on the distribution of such property to another partner within five years of its contribution to the partnership in an amount equal to the gain or loss that would have been allocated to such partner under section 704(c)(1)(A) and § 1.704-3 if the distributed property had been sold by the partnership to the distributee partner for its fair market value at the time of the distribution. See § 1.704-3(a)(3)(i) for a definition of section 704(c) property.

(2) *Transactions to which section 704(c)(1)(B) applies.* Section 704(c)(1)(B) and this section apply only to the extent that a distribution by a partnership is a distribution to a partner acting in the capacity of a partner within the meaning of section 731.

(3) *Fair market value of property.* The fair market value of the distributed section 704(c) property is the price at which the property would change hands between a willing buyer and a willing seller at the time of the distribution, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. The fair market value that a partnership assigns to distributed section 704(c) property will be regarded as correct, provided that the value is reasonably agreed to among the partners in an arm's-length negotiation and the partners have sufficiently adverse interests.

(4) *Determination of five-year period—*(i) *General rule.* The five-year period specified in paragraph (a)(1) of this section begins on and includes the date of contribution.

(ii) *Section 708(b)(1)(B) terminations.* A termination of the partnership under section 708(b)(1)(B) begins a new five-year period for each partner with respect to the built-in gain and built-in loss property that the partner is deemed to recontribute to a new partnership following the termination, but only to the extent that the pre-termination built-in gain or loss, if any, on such property would not have been allocated to the contributing partner under section 704(c)(1)(A) and § 1.704-3 on a sale of the contributed property to an unrelated party immediately before the termination. See § 1.704-3(a)(3)(ii) for the definitions of built-in gain and built-in loss on section 704(c) property.

(5) *Examples.* The following examples illustrate the rules of this paragraph (a). Unless otherwise specified, partnership income equals partnership expenses

(other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

Example 1. Recognition of gain. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes \$10,000 cash and Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$4,000. Thus, there is a built-in gain of \$6,000 on Property A at the time of contribution. B contributes \$10,000 cash and Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$10,000. C contributes \$20,000 cash.

(ii) On December 31, 1998, Property A and Property B are distributed to C in complete liquidation of C's interest in the partnership.

(iii) A would have recognized \$6,000 of gain under section 704(c)(1)(A) and § 1.704-3 on the sale of Property A at the time of the distribution (\$10,000 fair market value less \$4,000 adjusted tax basis). As a result, A must recognize \$6,000 of gain on the distribution of Property A to C. B would not have recognized any gain or loss under section 704(c)(1)(A) and § 1.704-3 on the sale of Property B at the time of distribution because Property B was not section 704(c) property. As a result, B does not recognize any gain or loss on the distribution of Property B.

Example 2. Effect of post-contribution depreciation deductions. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, depreciable property with a fair market value of \$30,000 and an adjusted tax basis of \$20,000. Therefore, there is a built-in gain of \$10,000 on Property A. B and C each contribute \$30,000 cash. ABC uses the traditional method of making section 704(c) allocations described in § 1.704-3(b) with respect to Property A.

(ii) Property A is depreciated using the straight-line method over its remaining 10-year recovery period. The partnership has book depreciation of \$3,000 per year (10 percent of the \$30,000 book basis), and each partner is allocated \$1,000 of book depreciation per year (one-third of the total annual book depreciation of \$3,000). The partnership has a tax depreciation deduction of \$2,000 per year (10 percent of the \$20,000 tax basis in Property A). This \$2,000 tax depreciation deduction is allocated equally between B and C, the noncontributing partners with respect to Property A.

(iii) At the end of the third year, the book value of Property A is \$21,000 (\$30,000 initial book value less \$9,000 aggregate book depreciation) and the adjusted tax basis is \$14,000 (\$20,000 initial tax basis less \$6,000 aggregate tax depreciation). A's remaining section 704(c)(1)(A) built-in gain with respect to Property A is \$7,000 (\$21,000 book value less \$14,000 adjusted tax basis).

(iv) On December 31, 1997, Property A is distributed to B in complete liquidation of B's interest in the partnership. If Property A had been sold for its fair market value at the

time of the distribution, A would have recognized \$7,000 of gain under section 704(c)(1)(A) and § 1.704-3(b). Therefore, A recognizes \$7,000 of gain on the distribution of Property A to B.

Example 3. Effect of remedial method. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A1, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$5,000, and Property A2, nondepreciable real property with a fair market value and adjusted tax basis of \$10,000. B and C each contribute \$20,000 cash. ABC uses the remedial method of making section 704(c) allocations described in § 1.704-3(d) with respect to Property A1.

(ii) On December 31, 1998, when the fair market value of Property A1 has decreased to \$7,000, Property A1 is distributed to C in a current distribution. If Property A1 had been sold by the partnership at the time of the distribution, ABC would have recognized the \$2,000 of remaining built-in gain under section 704(c)(1)(A) on the sale (fair market value of \$7,000 less \$5,000 adjusted tax basis). All of this gain would have been allocated to A. ABC would also have recognized a book loss of \$3,000 (\$10,000 original book value less \$7,000 current fair market value of the property). Book loss in the amount of \$2,000 would have been allocated equally between B and C. Under the remedial method, \$2,000 of tax loss would also have been allocated equally to B and C to match their share of the book loss. As a result, \$2,000 of gain would also have been allocated to A as an offsetting remedial allocation. A would have recognized \$4,000 of total gain under section 704(c)(1)(A) on the sale of Property A1 (\$2,000 of section 704(c) recognized gain plus \$2,000 remedial gain). Therefore, A recognizes \$4,000 of gain on the distribution of Property A1 to C under this section.

(b) Character of gain or loss—(1) General rule. Gain or loss recognized by the contributing partner under section 704(c)(1)(B) and this section has the same character as the gain or loss that would have resulted if the distributed property had been sold by the partnership to the distributee partner at the time of the distribution.

(2) Example. The following example illustrates the rule of this paragraph (b). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

Example. Character of gain. (i) On January 1, 1995, A and B form partnership AB. A contributes \$10,000 and Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$4,000, in exchange for a 25 percent interest in partnership capital and profits. B

contributes \$60,000 cash for a 75 percent interest in partnership capital and profits.

(ii) On December 31, 1998, Property A is distributed to B in a current distribution. Property A is used in a trade or business of B.

(iii) A would have recognized \$6,000 of gain under section 704(c)(1)(A) on a sale of Property A at the time of the distribution (the difference between the fair market value (\$10,000) and the adjusted tax basis (\$4,000) of the property at that time). Because Property A is not a capital asset in the hands of Partner B and B holds more than 50 percent of partnership capital and profits, the character of the gain on a sale of Property A to B would have been ordinary income under section 707(b)(2). Therefore, the character of the gain to A on the distribution of Property A to B is ordinary income.

(c) Exceptions—(1) Property contributed on or before October 3, 1989. Section 704(c)(1)(B) and this section do not apply to property contributed to the partnership on or before October 3, 1989.

(2) Certain liquidations. Section 704(c)(1)(B) and this section do not apply to a distribution of an interest in section 704(c) property to a partner other than the contributing partner in a liquidation of the partnership if—

(i) The contributing partner receives an interest in the section 704(c) property contributed by that partner (and no other property); and

(ii) The built-in gain or loss in the interest distributed to the contributing partner, determined immediately after the distribution, is equal to or greater than the built-in gain or loss on the property that would have been allocated to the contributing partner under section 704(c)(1)(A) and § 1.704-3 on a sale of the contributed property to an unrelated party immediately before the distribution.

(3) Section 708(b)(1)(B) termination. Section 704(c)(1)(B) and this section do not apply to a deemed distribution of property caused by a termination of the partnership under section 708(b)(1)(B). See paragraph (a)(4)(ii) of this section for a special rule regarding a new five-year period for certain property deemed contributed to a new partnership following a termination of the partnership under section 708(b)(1)(B). See also § 1.737-2(a) for a similar rule in the context of section 737.

(4) Complete transfer to another partnership. Section 704(c)(1)(B) and this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of

the transferor partnership as part of the same plan or arrangement. A subsequent distribution of section 704(c) property by the transferee partnership to a partner of the transferee partnership is subject to section 704(c)(1)(B) to the same extent that a distribution by the transferor partnership would have been subject to section 704(c)(1)(B). See § 1.737-2(b) for a similar rule in the context of section 737.

(5) Incorporation of a partnership. Section 704(c)(1)(B) and this section do not apply to an incorporation of a partnership by any method of incorporation (other than a method involving an actual distribution of partnership property to the partners followed by a contribution of that property to a corporation), provided that the partnership is liquidated as part of the incorporation transaction. See § 1.737-2(c) for a similar rule in the context of section 737.

(6) Undivided interests. Section 704(c)(1)(B) and this section do not apply to a distribution of an undivided interest in property to the extent that the undivided interest does not exceed the undivided interest, if any, contributed by the distributee partner in the same property. See § 1.737-2(d)(4) for the application of section 737 in a similar context. The portion of the undivided interest in property retained by the partnership after the distribution, if any, that is treated as contributed by the distributee partner, is reduced to the extent of the undivided interest distributed to the distributee partner.

(7) Example. The following example illustrates the rule of paragraph (c)(2) of this section. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

Example. (i) On January 1, 1995, A and B form partnership AB, as equal partners. A contributes Property A, nondepreciable real property with a fair market value and adjusted tax basis of \$20,000. B contributes Property B, nondepreciable real property with a fair market value of \$20,000 and an adjusted tax basis of \$10,000. Property B therefore has a built-in gain of \$10,000 at the time of contribution.

(ii) On December 31, 1998, the partnership liquidates when the fair market value of Property A has not changed, but the fair market value of Property B has increased to \$40,000.

(iii) In the liquidation, A receives Property A and a 25 percent interest in Property B. This interest in Property B has a fair market

value of \$10,000 to A, reflecting the fact that A was entitled to 50 percent of the \$20,000 post-contribution appreciation in Property B. The partnership distributes to B a 75 percent interest in Property B with a fair market value of \$30,000. B's basis in this portion of Property B is \$10,000 under section 732(b). As a result, B has a built-in gain of \$20,000 in this portion of Property B immediately after the distribution (\$30,000 fair market value less \$10,000 adjusted tax basis). This built-in gain is greater than the \$10,000 of built-in gain in Property B at the time of contribution to the partnership. B therefore does not recognize any gain on the distribution of a portion of Property B to A under this section.

(d) *Special rules*—(1) *Nonrecognition transactions*. Property received by the partnership in exchange for section 704(c) property in a nonrecognition transaction is treated as the section 704(c) property for purposes of section 704(c)(1)(B) and this section to the extent that the property received is treated as section 704(c) property under § 1.704-3(a)(8). See § 1.737-2(d)(3) for a similar rule in the context of section 737.

(2) *Transfers of a partnership interest*. The transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of section 704(c)(1)(B) and this section to the extent of the share of built-in gain or loss allocated to the transferee partner. See § 1.704-3(a)(7).

(3) *Distributions of like-kind property*. If section 704(c) property is distributed to a partner other than the contributing partner and like-kind property (within the meaning of section 1031) is distributed to the contributing partner no later than the earlier of (i) 180 days following the date of the distribution to the non-contributing partner, or (ii) the due date (determined with regard to extensions) of the contributing partner's income tax return for the taxable year of the distribution to the noncontributing partner, the amount of gain or loss, if any, that the contributing partner would otherwise have recognized under section 704(c)(1)(B) and this section is reduced by the amount of built-in gain or loss in the distributed like-kind property in the hands of the contributing partner immediately after the distribution. The contributing partner's basis in the distributed like-kind property is determined as if the like-kind property were distributed in an unrelated distribution prior to the distribution of any other property distributed as part of the same distribution and is determined without regard to the increase in the contributing partner's adjusted tax basis in the partnership interest under section

704(c)(1)(B) and this section. See § 1.707-3 for provisions treating the distribution of the like-kind property to the contributing partner as a disguised sale in certain situations.

(4) *Example*. The following example illustrates the rules of this paragraph (d). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

Example. Distribution of like-kind property. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of \$20,000 and an adjusted tax basis of \$10,000. B and C each contribute \$20,000 cash. The partnership subsequently buys Property X, nondepreciable real property of a like-kind to Property A with a fair market value and adjusted tax basis of \$8,000. The fair market value of Property X subsequently increases to \$10,000.

(ii) On December 31, 1998, Property A is distributed to B in a current distribution. At the same time, Property X is distributed to A in a current distribution. The distribution of Property X does not result in the contribution of Property A being properly characterized as a disguised sale to the partnership under § 1.707-3. A's basis in Property X is \$8,000 under section 732(a)(1). A therefore has \$2,000 of built-in gain in Property X (\$10,000 fair market value less \$8,000 adjusted tax basis).

(iii) A would generally recognize \$10,000 of gain under section 704(c)(1)(B) on the distribution of Property A, the difference between the fair market value (\$20,000) of the property and its adjusted tax basis (\$10,000). This gain is reduced, however, by the amount of the built-in gain of Property X in the hands of A. As a result, A recognizes only \$8,000 of gain on the distribution of Property A to B under section 704(c)(1)(B) and this section.

(e) *Basis adjustments*—(1) *Contributing partner's basis in the partnership interest*. The basis of the contributing partner's interest in the partnership is increased by the amount of the gain, or decreased by the amount of the loss, recognized by the partner under section 704(c)(1)(B) and this section. This increase or decrease is taken into account in determining (i) the contributing partner's adjusted tax basis under section 732 for any property distributed to the partner in a distribution that is part of the same distribution as the distribution of the contributed property, other than like-kind property described in paragraph (d)(3) of this section (pertaining to the

special rule for distributions of like-kind property), and (ii) the amount of the gain recognized by the contributing partner under section 731 or section 737, if any, on a distribution of money or property to the contributing partner that is part of the same distribution as the distribution of the contributed property. For a determination of basis in a distribution subject to section 737, see § 1.737-3(a).

(2) *Partnership's basis in partnership property*. The partnership's adjusted tax basis in the distributed section 704(c) property is increased or decreased immediately before the distribution by the amount of gain or loss recognized by the contributing partner under section 704(c)(1)(B) and this section. Any increase or decrease in basis is therefore taken into account in determining the distributee partner's adjusted tax basis in the distributed property under section 732. For a determination of basis in a distribution subject to section 737, see § 1.737-3(b).

(3) *Section 754 adjustments*. The basis adjustments to partnership property made pursuant to paragraph (e)(2) of this section are not elective and must be made regardless of whether the partnership has an election in effect under section 754. Any adjustments to the bases of partnership property (including the distributed section 704(c) property) under section 734(b) pursuant to a section 754 election must be made after (and must take into account) the adjustments to basis made under paragraph (e)(2) of this section. See § 1.737-3(c)(4) for a similar rule in the context of section 737.

(4) *Example*. The following example illustrates the rules of this paragraph (e). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

Example. Basis adjustment. On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes \$10,000 cash and Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$4,000. B and C each contribute \$20,000 cash.

(i) On December 31, 1998, Property A is distributed to B in a current distribution.

(ii) Under paragraph (a) of this section, A recognizes \$6,000 of gain on the distribution of Property A because that is the amount of gain that would have been allocated to A under section 704(c)(1)(A) and § 1.704-3 on a sale of Property A for its fair market value at the time of the distribution (fair market value of Property A (\$10,000) less its

adjusted tax basis at the time of distribution (\$4,000). The adjusted tax basis of A's partnership interest is increased from \$14,000 to \$20,000 to reflect this gain. The partnership's adjusted tax basis in Property A is increased from \$4,000 to \$10,000 immediately prior to its distribution to B. B's adjusted tax basis in Property A is therefore \$10,000 under section 732(a)(1).

(f) *Anti-abuse rule—(1) In general.* The rules of section 704(c)(1)(B) and this section must be applied in a manner consistent with the purpose of section 704(c)(1)(B). Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 704(c)(1)(B), the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 704(c)(1)(B) and this section. Whether a tax result is inconsistent with the purpose of section 704(c)(1)(B) and this section must be determined based on all the facts and circumstances. See § 1.737-4 for an anti-abuse rule and examples in the context of section 737.

(2) *Examples.* The following examples illustrate the anti-abuse rule of this paragraph (f). The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

Example 1. Distribution in substance made within five-year period; results inconsistent with the purpose of section 704(c)(1)(B). (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$1,000. B and C each contributes \$10,000 cash.

(ii) On December 31, 1998, the partners desire to distribute Property A to B in complete liquidation of B's interest in the partnership. If Property A were distributed at that time, however, A would recognize \$9,000 of gain under section 704(c)(1)(B), the difference between the \$10,000 fair market value and the \$1,000 adjusted tax basis of Property A, because Property A was contributed to the partnership less than five years before December 31, 1998. On becoming aware of this potential gain recognition, and with a principal purpose of

avoiding such gain, the partners amend the partnership agreement on December 31, 1998, and take any other steps necessary to provide that substantially all of the economic risks and benefits of Property A are borne by B as of December 31, 1998, and that substantially all of the economic risks and benefits of all other partnership property are borne by A and C. The partnership holds Property A until January 5, 2000, at which time it is distributed to B in complete liquidation of B's interest in the partnership.

(iii) The actual distribution of Property A occurred more than five years after the contribution of the property to the partnership. The steps taken by the partnership on December 31, 1998, however, are the functional equivalent of an actual distribution of Property A to B in complete liquidation of B's interest in the partnership as of that date. Section 704(c)(1)(B) requires recognition of gain when contributed section 704(c) property is in substance distributed to another partner within five years of its contribution to the partnership. Allowing a contributing partner to avoid section 704(c)(1)(B) through arrangements such as those in this *Example 1* that have the effect of a distribution of property within five years of the date of its contribution to the partnership would effectively undermine the purpose of section 704(c)(1)(B) and this section. As a result, the steps taken by the partnership on December 31, 1998, are treated as causing a distribution of Property A to B for purposes of section 704(c)(1)(B) on that date, and A recognizes gain of \$9,000 under section 704(c)(1)(B) and this section at that time.

(iv) Alternatively, if on becoming aware of the potential gain recognition to A on a distribution of Property A on December 31, 1998, the partners had instead agreed that B would continue as a partner with no changes to the partnership agreement or to B's economic interest in partnership operations, the distribution of Property A to B on January 5, 2000, would not have been inconsistent with the purpose of section 704(c)(1)(B) and this section. In that situation, Property A would not have been distributed until after the expiration of the five-year period specified in section 704(c)(1)(B) and this section. Deferring the distribution of Property A until the end of the five-year period for a principal purpose of avoiding the recognition of gain under section 704(c)(1)(B) and this section is not inconsistent with the purpose of section 704(c)(1)(B). Therefore, A would not have recognized gain on the distribution of Property A in that case.

Example 2. Suspension of five-year period in manner consistent with the purpose of section 704(c)(1)(B). (i) A, B, and C form partnership ABC on January 1, 1995, to conduct bona fide business activities. A contributes Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$1,000, in exchange for a 49.5 percent interest in partnership capital and profits. B contributes \$10,000 in cash for a 49.5 percent interest in partnership capital and profits. C contributes cash for a 1 percent interest in partnership capital and profits. A and B are wholly owned subsidiaries of the same affiliated

group and continue to control the management of Property A by virtue of their controlling interests in the partnership. The partnership is formed pursuant to a plan a principal purpose of which is to minimize the period of time that A would have to remain a partner with a potential acquirer of Property A.

(ii) On December 31, 1997, D is admitted as a partner to the partnership in exchange for \$10,000 cash.

(iii) On January 5, 2000, Property A is distributed to D in complete liquidation of D's interest in the partnership.

(iv) The distribution of Property A to D occurred more than five years after the contribution of the property to the partnership. On these facts, however, a principal purpose of the transaction was to minimize the period of time that A would have to remain partners with a potential acquirer of Property A, and treating the five-year period of section 704(c)(1)(B) as running during a time when Property A was still effectively owned through the partnership by members of the contributing affiliated group of which A is a member is inconsistent with the purpose of section 704(c)(1)(B). Prior to the admission of D as a partner, the pooling of assets between A and B, on the one hand, and C, on the other hand, although sufficient to constitute ABC as a valid partnership for federal income tax purposes, is not a sufficient pooling of assets for purposes of running the five-year period with respect to the distribution of Property A to D. Allowing a contributing partner to avoid section 704(c)(1)(B) through arrangements such as those in this *Example 2* would have the effect of substantially nullifying the five-year requirement of section 704(c)(1)(B) and this section and elevating the form of the transaction over its substance. As a result, with respect to the distribution of Property A to D, the five-year period of section 704(c)(1)(B) is tolled until the admission of D as a partner on December 31, 1997. Therefore, the distribution of Property A occurred before the end of the five-year period of section 704(c)(1)(B), and A recognizes gain of \$9,000 under section 704(c)(1)(B) on the distribution.

(g) *Effective date.* This section applies to distributions by a partnership to a partner on or after January 9, 1995.

Par. 3. Sections 1.737-1, 1.737-2, 1.737-3, 1.737-4, and 1.737-5 are added to read as follows:

§ 1.737-1 Recognition of precontribution gain.

(a) *Determination of gain—(1) In general.* A partner that receives a distribution of property (other than money) must recognize gain under section 737 and this section in an amount equal to the lesser of the excess distribution (as defined in paragraph (b) of this section) or the partner's net precontribution gain (as defined in paragraph (c) of this section). Gain recognized under section 737 and this section is in addition to any gain recognized under section 731.

(2) *Transactions to which section 737 applies.* Section 737 and this section apply only to the extent that a distribution by a partnership is a distribution to a partner acting in the capacity of a partner within the meaning of section 731, except that section 737 and this section do not apply to the extent that section 751(b) applies to the distribution.

(b) *Excess distribution*—(1) *Definition.* The excess distribution is the amount (if any) by which the fair market value of the distributed property (other than money) exceeds the distributee partner's adjusted tax basis in the partner's partnership interest.

(2) *Fair market value of property.* The fair market value of the distributed property is the price at which the property would change hands between a willing buyer and a willing seller at the time of the distribution, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. The fair market value that a partnership assigns to distributed property will be regarded as correct, provided that the value is reasonably agreed to among the partners in an arm's-length negotiation and the partners have sufficiently adverse interests.

(3) *Distributee partner's adjusted tax basis*—(i) *General rule.* In determining the amount of the excess distribution, the distributee partner's adjusted tax basis in the partnership interest includes any basis adjustment resulting from the distribution that is subject to section 737 (for example, adjustments required under section 752) and from any other distribution or transaction that is part of the same distribution, except for—

(A) The increase required under section 737(c)(1) for the gain recognized by the partner under section 737; and

(B) The decrease required under section 733(2) for any property distributed to the partner other than property previously contributed to the partnership by the distributee partner. See § 1.704-4(e)(1) for a rule in the context of section 704(c)(1)(B). See also § 1.737-3(b)(2) for a special rule for determining a partner's adjusted tax basis in distributed property previously contributed by the partner to the partnership.

(ii) *Advances or drawings.* The distributee partner's adjusted tax basis in the partnership interest is determined as of the last day of the partnership's taxable year if the distribution to which section 737 applies is properly characterized as an advance or drawing against the partner's distributive share of income. See § 1.731-1(a)(1)(ii).

(c) *Net precontribution gain*—(1) *General rule.* The distributee partner's net precontribution gain is the net gain (if any) that would have been recognized by the distributee partner under section 704(c)(1)(B) and § 1.704-4 if all property that had been contributed to the partnership by the distributee partner within five years of the distribution and is held by the partnership immediately before the distribution had been distributed by the partnership to another partner other than a partner who owns, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership. See § 1.704-4 for provisions determining a contributing partner's gain or loss under section 704(c)(1)(B) on an actual distribution of contributed section 704(c) property to another partner.

(2) *Special rules*—(i) *Property contributed on or before October 3, 1989.* Property contributed to the partnership on or before October 3, 1989, is not taken into account in determining a partner's net precontribution gain. See § 1.704-4(c)(1) for a similar rule in the context of section 704(c)(1)(B).

(ii) *Section 734(b)(1)(A) adjustments.* For distributions to a distributee partner of money by a partnership with a section 754 election in effect that are part of the same distribution as the distribution of property subject to section 737, for purposes of paragraph (a) and (c)(1) of this section the distributee partner's net precontribution gain is reduced by the basis adjustments (if any) made to section 704(c) property contributed by the distributee partner under section 734(b)(1)(A). See § 1.737-3(c)(4) for rules regarding basis adjustments for partnerships with a section 754 election in effect.

(iii) *Transfers of a partnership interest.* The transferee of all or a portion of a contributing partner's partnership interest succeeds to the transferor's net precontribution gain, if any, in an amount proportionate to the interest transferred. See § 1.704-3(a)(7) and § 1.704-4(d)(2) for similar provisions in the context of section 704(c)(1)(A) and section 704(c)(1)(B).

(iv) *Section 704(c)(1)(B) gain recognized in related distribution.* A distributee partner's net precontribution gain is determined after taking into account any gain or loss recognized by the partner under section 704(c)(1)(B) and § 1.704-4 (or that would have been recognized by the partner except for the like-kind exception in section 704(c)(2) and § 1.704-4(d)(3)) on an actual distribution to another partner of section 704(c) property contributed by

the distributee partner that is part of the same distribution as the distribution to the distributee partner.

(v) *Section 704(c)(2) disregarded.* A distributee partner's net precontribution gain is determined without regard to the provisions of section 704(c)(2) and § 1.704-4(d)(3) in situations in which the property contributed by the distributee partner is not actually distributed to another partner in a distribution related to the section 737 distribution.

(d) *Character of gain.* The character of the gain recognized by the distributee partner under section 737 and this section is determined by, and is proportionate to, the character of the partner's net precontribution gain. For this purpose, all gains and losses on section 704(c) property taken into account in determining the partner's net precontribution gain are netted according to their character. Character is determined at the partnership level for this purpose, and any character with a net negative amount is disregarded. The character of the partner's gain under section 737 is the same as, and in proportion to, any character with a net positive amount. Character for this purpose is determined as if the section 704(c) property had been sold by the partnership to an unrelated third party at the time of the distribution and includes any item that would have been taken into account separately by the contributing partner under section 702(a) and § 1.702-1(a).

(e) *Examples.* The following examples illustrate the provisions of this section. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 737, and all partners are unrelated.

Example 1. Calculation of excess distribution and net precontribution gain. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, depreciable real property with a fair market value of \$30,000 and an adjusted tax basis of \$20,000. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$30,000. C contributes \$30,000 cash.

(ii) Property A has 10 years remaining on its cost recovery schedule and is depreciated using the straight-line method. The partnership uses the traditional method for allocating items under section 704(c) described in § 1.704-3(b)(1) for Property A. The partnership has book depreciation of \$3,000 per year (10 percent of the \$30,000 book basis in Property A) and each partner

is allocated \$1,000 of book depreciation per year (one-third of the total annual book depreciation of \$3,000). The partnership also has tax depreciation of \$2,000 per year (10 percent of the \$20,000 adjusted tax basis in Property A). This \$2,000 tax depreciation is allocated equally between B and C, the noncontributing partners with respect to Property A.

(iii) At the end of 1997, the book value of Property A is \$21,000 (\$30,000 initial book value less \$9,000 aggregate book depreciation) and its adjusted tax basis is \$14,000 (\$20,000 initial tax basis less \$6,000 aggregate tax depreciation).

(iv) On December 31, 1997, Property B is distributed to A in complete liquidation of A's partnership interest. The adjusted tax basis of A's partnership interest at that time is \$20,000. The amount of the excess distribution is \$10,000, the difference between the fair market value of the distributed Property B (\$30,000) and A's adjusted tax basis in A's partnership interest (\$20,000). A's net precontribution gain is \$7,000, the difference between the book value of Property A (\$21,000) and its adjusted tax basis at the time of the distribution (\$14,000). A recognizes gain of \$7,000 on the distribution, the lesser of the excess distribution and the net precontribution gain.

Example 2. Determination of distributee partner's basis. (i) On January 1, 1995, A, B, and C form general partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$4,000. B and C each contributes \$10,000 cash.

(ii) The partnership purchases Property B, nondepreciable real property with a fair market value of \$9,000, subject to a \$9,000 nonrecourse liability. This nonrecourse liability is allocated equally among the partners under section 752, increasing A's adjusted tax basis in A's partnership interest from \$4,000 to \$7,000.

(iii) On December 31, 1998, A receives \$2,000 cash and Property B, subject to the \$9,000 liability, in a current distribution.

(iv) In determining the amount of the excess distribution, the adjusted tax basis of A's partnership interest is adjusted to take into account the distribution of money and the shift in liabilities. A's adjusted tax basis is therefore increased to \$11,000 for this purpose (\$7,000 initial adjusted tax basis, less \$2,000 distribution of money, less \$3,000 (decrease in A's share of the \$9,000 partnership liability), plus \$9,000 (increase in A's individual liabilities)). As a result of this basis adjustment, the adjusted tax basis of A's partnership interest (\$11,000) is greater than the fair market value of the distributed property (\$9,000) and therefore, there is no excess distribution. A recognizes no gain under section 737.

Example 3. Net precontribution gain reduced for gain recognized under section 704(c)(1)(B). (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Properties A1 and A2, nondepreciable real properties located in the United States each with a fair market value of \$10,000 and an adjusted tax basis of

\$6,000. B contributes Property B, nondepreciable real property located outside the United States, with a fair market value and adjusted tax basis of \$20,000. C contributes \$20,000 cash.

(ii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest and, as part of the same distribution, Property A1 is distributed to B in a current distribution.

(iii) A's net precontribution gain before the distribution is \$8,000 (\$20,000 fair market value of Properties A1 and A2 less \$12,000 adjusted tax basis of such properties). A recognizes \$4,000 of gain under section 704(c)(1)(B) and § 1.704-4 on the distribution of Property A1 to B (\$10,000 fair market value of Property A1 less \$6,000 adjusted tax basis of Property A1). This gain is taken into account in determining A's excess distribution and net precontribution gain. As a result, A's net precontribution gain is reduced from \$8,000 to \$4,000, and the adjusted tax basis in A's partnership interest is increased by \$4,000 to \$16,000.

(iv) A recognizes gain of \$4,000 on the receipt of Property B under section 737, an amount equal to the lesser of the excess distribution of \$4,000 (\$20,000 fair market value of Property B less \$16,000 adjusted tax basis of A's interest in the partnership) and A's remaining net precontribution gain of \$4,000.

Example 4. Character of gain. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable property to the partnership:

	Fair market value	Adjusted tax basis
Property A1	\$30,000	\$20,000
Property A2	30,000	38,000
Property A3	10,000	9,000

(ii) The character of gain or loss on Property A1 and Property A2 is long-term, U.S.-source capital gain or loss. The character of gain on Property A3 is long-term, foreign-source capital gain. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$70,000. C contributes \$70,000 cash.

(iii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest in the partnership. A recognizes \$3,000 of gain under section 737, an amount equal to the excess distribution of \$3,000 (\$70,000 fair market value of Property B less \$67,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain of \$3,000 (\$70,000 aggregate fair market value of properties contributed by A less \$67,000 aggregate adjusted tax basis of such properties).

(iv) In determining the character of A's gain, all gains and losses on property taken into account in determining A's net precontribution gain are netted according to their character and allocated to A's recognized gain under section 737 based on the relative proportions of the net positive amounts. U.S.-source and foreign-source gains must be netted separately because A would have been required to take such gains

into account separately under section 702. As a result, A's net precontribution gain of \$3,000 consists of \$2,000 of net long-term, U.S.-source capital gain (\$10,000 gain on Property A1 and \$8,000 loss on Property A2) and \$1,000 of net long-term, foreign-source capital gain (\$1,000 gain on Property A3).

(v) The character of A's gain under paragraph (d) of this section is therefore \$2,000 long-term, U.S.-source capital gain (\$3,000 gain recognized under section 737 × \$2,000 net long-term, U.S.-source capital gain/\$3,000 total net precontribution gain) and \$1,000 long-term, foreign-source capital gain (\$3,000 gain recognized under section 737 × \$1,000 net long-term, foreign-source capital gain/\$3,000 total net precontribution gain).

§ 1.737-2 Exceptions and special rules.

(a) **Section 708(b)(1)(B) terminations.** Section 737 and this section do not apply to a deemed distribution of property caused by a termination of the partnership under section 708(b)(1)(B). See § 1.704-4(c)(3) for a similar rule in the context of section 704(c)(1)(B).

(b) **Transfers to another partnership—**(1) **Complete transfer.** Section 737 and this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement. See § 1.704-4(c)(4) for a similar rule in the context of section 704(c)(1)(B).

(2) **Certain divisive transactions.** Section 737 and this section do not apply to a transfer by a partnership (transferor partnership) of all of the section 704(c) property contributed by a partner to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution as part of the same plan or arrangement of an interest in the transferee partnership (and no other property) in complete liquidation of the interest of the partner that originally contributed the section 704(c) property to the transferor partnership.

(3) **Subsequent distributions.** A subsequent distribution of property by the transferee partnership to a partner of the transferee partnership that was formerly a partner of the transferor partnership is subject to section 737 to the same extent that a distribution from the transferor partnership would have been subject to section 737.

(c) **Incorporation of a partnership.** Section 737 and this section do not apply to an incorporation of a partnership by any method of incorporation (other than a method involving an actual distribution of

partnership property to the partners followed by a contribution of that property to a corporation), provided that the partnership is liquidated as part of the incorporation transaction. See § 1.704-4(c)(5) for a similar rule in the context of section 704(c)(1)(B).

(d) *Distribution of previously contributed property*—(1) *General rule.* Any portion of the distributed property that consists of property previously contributed by the distributee partner (including property treated as contributed by the partner in connection with a termination of the partnership under section 708(b)(1)(B)) (*previously contributed property*) is not taken into account in determining the amount of the excess distribution or the partner's net precontribution gain. See § 1.737-3(b)(2) for a special rule for determining the basis of previously contributed property in the hands of a distributee partner who contributed the property to the partnership.

(2) *Limitation for distribution of previously contributed interest in an entity.* An interest in an entity previously contributed to the partnership is not treated as previously contributed property to the extent that the value of the interest is attributable to property contributed to the entity after the interest was contributed to the partnership. The preceding sentence does not apply to the extent that the property contributed to the entity was contributed to the partnership by the partner that also contributed the interest in the entity to the partnership.

(3) *Nonrecognition transactions.* Property received by the partnership in exchange for contributed section 704(c) property in a nonrecognition transaction is treated as the contributed property with regard to the contributing partner for purposes of section 737 to the extent that the property received is treated as section 704(c) property under § 1.704-3(a)(8). See § 1.704-4(d)(1) for a similar rule in the context of section 704(c)(1)(B).

(4) *Undivided interests.* The distribution of an undivided interest in property is treated as the distribution of previously contributed property to the extent that the undivided interest does not exceed the undivided interest, if any, contributed by the distributee partner in the same property. See § 1.704-4(c)(6) for the application of section 704(c)(1)(B) in a similar context. The portion of the undivided interest in property retained by the partnership after the distribution, if any, that is treated as contributed by the distributee partner, is reduced to the extent of the undivided interest distributed to the distributee partner.

(e) *Examples.* The following examples illustrate the rules of this section. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 737, and all partners are unrelated.

Example 1. Distribution of previously contributed property. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable real property to the partnership:

	Fair market value	Adjusted tax basis
Property A1	\$20,000	\$10,000
Property A2	10,000	6,000

(ii) A's total net precontribution gain on the contributed property is \$14,000 (\$10,000 on Property A1 plus \$4,000 on Property A2). B contributes \$10,000 cash and Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$20,000. C contributes \$30,000 cash.

(iii) On December 31, 1998, Property A2 and Property B are distributed to A in complete liquidation of A's interest in the partnership. Property A2 was previously contributed by A and is therefore not taken into account in determining the amount of the excess distribution or A's net precontribution gain. The adjusted tax basis of Property A2 in the hands of A is also determined under section 732 as if that property were the only property distributed to A.

(iv) As a result of excluding Property A2 from these determinations, the amount of the excess distribution is \$10,000 (\$20,000 fair market value of distributed Property B less \$10,000 adjusted tax basis in A's partnership interest). A's net precontribution gain is also \$10,000 (\$14,000 total net precontribution gain less \$4,000 gain with respect to previously contributed Property A2). A therefore recognizes \$10,000 of gain on the distribution, the lesser of the excess distribution and the net precontribution gain.

Example 2. Distribution of a previously contributed interest in an entity. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$5,000, and all of the stock of Corporation X with a fair market value and adjusted tax basis of \$500. B contributes \$500 cash and Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$10,000. Partner C contributes \$10,500 cash. On December 31, 1996, ABC contributes Property B to Corporation X in a nonrecognition transaction under section 351.

(ii) On December 31, 1998, all of the stock of Corporation X is distributed to A in complete liquidation of A's interest in the

partnership. The stock is treated as previously contributed property with respect to A only to the extent of the \$500 fair market value of the Corporation X stock contributed by A. The fair market value of the distributed stock for purposes of determining the amount of the excess distribution is therefore \$10,000 (\$10,500 total fair market value of Corporation X stock less \$500 portion treated as previously contributed property). The \$500 fair market value and adjusted tax basis of the Corporation X stock is also not taken into account in determining the amount of the excess distribution and the net precontribution gain.

(iii) A recognizes \$5,000 of gain under section 737, the amount of the excess distribution (\$10,000 fair market value of distributed property less \$5,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain (\$10,000 fair market value of Property A less \$5,000 adjusted tax basis in Property A).

Example 3. Distribution of undivided interest in property. (i) On January 1, 1995, A and B form partnership AB as equal partners. A contributes \$500 cash and an undivided one-half interest in Property X. B contributes \$500 cash and an undivided one-half interest in Property X.

(ii) On December 31, 1998, an undivided one-half interest in Property X is distributed to A in a current distribution. The distribution of the undivided one-half interest in Property X is treated as a distribution of previously contributed property because A contributed an undivided one-half interest in Property X. As a result, A does not recognize any gain under section 737 on the distribution.

§ 1.737-3 Basis adjustments; Recovery rules.

(a) *Distributee partner's adjusted tax basis in the partnership interest.* The distributee partner's adjusted tax basis in the partnership interest is increased by the amount of gain recognized by the distributee partner under section 737 and this section. This increase is not taken into account in determining the amount of gain recognized by the partner under section 737(a)(1) and this section or in determining the amount of gain recognized by the partner under section 731(a) on the distribution of money in the same distribution or any related distribution. See § 1.704-4(e)(1) for a determination of the distributee partner's adjusted tax basis in a distribution subject to section 704(c)(1)(B).

(b) *Distributee partner's adjusted tax basis in distributed property*—(1) *In general.* The distributee partner's adjusted tax basis in the distributed property is determined under section 732 (a) or (b) as applicable. The increase in the distributee partner's adjusted tax basis in the partnership interest under paragraph (a) of this section is taken into account in determining the distributee partner's adjusted tax basis

in the distributed property other than property previously contributed by the partner. See § 1.704-4(e)(2) for a determination of basis in a distribution subject to section 704(c)(1)(B).

(2) *Previously contributed property.* The distributee partner's adjusted tax basis in distributed property that the partner previously contributed to the partnership is determined as if it were distributed in a separate and independent distribution prior to the distribution that is subject to section 737 and § 1.737-1.

(c) *Partnership's adjusted tax basis in partnership property*—(1) *Increase in basis.* The partnership's adjusted tax basis in eligible property is increased by the amount of gain recognized by the distributee partner under section 737.

(2) *Eligible property.* Eligible property is property that—

(i) Entered into the calculation of the distributee partner's net precontribution gain;

(ii) Has an adjusted tax basis to the partnership less than the property's fair market value at the time of the distribution;

(iii) Would have the same character of gain on a sale by the partnership to an unrelated party as the character of any of the gain recognized by the distributee partner under section 737; and

(iv) Was not distributed to another partner in a distribution subject to section 704(c)(1)(B) and § 1.704-4 that was part of the same distribution as the distribution subject to section 737.

(3) *Method of adjustment.* For the purpose of allocating the basis increase under paragraph (c)(2) of this section among the eligible property, all eligible property of the same character is treated as a single group. Character for this purpose is determined in the same manner as the character of the recognized gain is determined under § 1.737-1(d). The basis increase is allocated among the separate groups of eligible property in proportion to the character of the gain recognized under section 737. The basis increase is then allocated among property within each group in the order in which the property was contributed to the partnership by the partner, starting with the property contributed first, in an amount equal to the difference between the property's fair market value and its adjusted tax basis to the partnership at the time of the distribution. For property that has the same character and was contributed in the same (or a related) transaction, the basis increase is allocated based on the respective amounts of unrealized appreciation in such properties at the time of the distribution.

(4) *Section 754 adjustments.* The basis adjustments to partnership property made pursuant to paragraph (c)(1) of this section are not elective and must be made regardless of whether the partnership has an election in effect under section 754. Any adjustments to the bases of partnership property (including eligible property as defined in paragraph (c)(2) of this section) under section 734(b) pursuant to a section 754 election (other than basis adjustments under section 734(b)(1)(A) described in the following sentence) must be made after (and must take into account) the adjustments to basis made under paragraph (a) and paragraph (c)(1) of this section. Basis adjustments under section 734(b)(1)(A) that are attributable to distributions of money to the distributee partner that are part of the same distribution as the distribution of property subject to section 737 are made before the adjustments to basis under paragraph (a) and paragraph (c)(1) of this section. See § 1.737-1(c)(2)(ii) for the effect, if any, of basis adjustments under section 734(b)(1)(A) on a partner's net precontribution gain. See also § 1.704-4(e)(3) for a similar rule regarding basis adjustments pursuant to a section 754 election in the context of section 704(c)(1)(B).

(d) *Recovery of increase to adjusted tax basis.* Any increase to the adjusted tax basis of partnership property under paragraph (c)(1) of this section is recovered using any applicable recovery period and depreciation (or other cost recovery) method (including first-year conventions) available to the partnership for newly purchased property (of the type adjusted) placed in service at the time of the distribution.

(e) *Examples.* The following examples illustrate the rules of this section. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 737, and all partners are unrelated.

(e) *Example 1. Partner's basis in distributed property.* (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$5,000. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$10,000. C contributes \$10,000 cash.

(ii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest in the partnership. A recognizes \$5,000 of gain under section 737, an amount equal to the excess distribution of \$5,000

(\$10,000 fair market value of Property B less \$5,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain of \$5,000 (\$10,000 fair market value of Property A less \$5,000 adjusted tax basis of such property).

(iii) A's adjusted tax basis in A's partnership interest is increased by the \$5,000 of gain recognized under section 737. This increase is taken into account in determining A's basis in the distributed property. Therefore, A's adjusted tax basis in distributed Property B is \$10,000 under section 732(b).

Example 2. Partner's basis in distributed property in connection with gain recognized under section 704(c)(1)(B). (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable real property to the partnership:

	Fair market value	Adjusted tax basis
Property A1	\$10,000	5,000
Property A2	10,000	2,000

(ii) B contributes \$10,000 cash and Property B, nondepreciable real property, with a fair market value and adjusted tax basis of \$10,000. C contributes \$20,000 cash.

(iii) On December 31, 1998, Property B is distributed to A in a current distribution and Property A1 is distributed to B in a current distribution. A recognizes \$5,000 of gain under section 704(c)(1)(B) and § 1.704-4 on the distribution of Property A1 to B, the difference between the fair market value of such property (\$10,000) and the adjusted tax basis in distributed Property A1 (\$5,000). The adjusted tax basis of A's partnership interest is increased by this \$5,000 of gain under section 704(c)(1)(B) and § 1.704-4(e)(1).

(iv) The increase in the adjusted tax basis of A's partnership interest is taken into account in determining the amount of the excess distribution. As a result, there is no excess distribution because the fair market value of Property B (\$10,000) is less than the adjusted tax basis of A's interest in the partnership at the time of distribution (\$12,000). A therefore recognizes no gain under section 737 on the receipt of Property B. A's adjusted tax basis in Property B is \$10,000 under section 732(a)(1). The adjusted tax basis of A's partnership interest is reduced from \$12,000 to \$2,000 under section 733. See *Example 3* of § 1.737-1(e).

Example 3. Partnership's basis in partnership property after a distribution with section 737 gain. (i) On January 31, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable property to the partnership:

	Fair market value	Adjusted tax basis
Property A1	\$1,000	\$500
Property A2	4,000	1,500
Property A3	4,000	6,000
Property A4	6,000	4,000

(ii) The character of gain or loss on Properties A1, A2, and A3 is long-term, U.S.-

source capital gain or loss. The character of gain on Property A4 is long-term, foreign-source capital gain. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$15,000. C contributes \$15,000 cash.

(iii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest in the partnership. A recognizes gain of \$3,000 under section 737, an amount equal to the excess distribution of \$3,000 (\$15,000 fair market value of Property B less \$12,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain of \$3,000 (\$15,000 aggregate fair market value of the property contributed by A less \$12,000 aggregate adjusted tax basis of such property).

(iv) \$2,000 of A's gain is long-term, foreign-source capital gain (\$3,000 total gain under section 737 x \$2,000 net long-term, foreign-source capital gain/\$3,000 total net precontribution gain). \$1,000 of A's gain is long-term, U.S.-source capital gain (\$3,000 total gain under section 737 x \$1,000 net long-term, U.S.-source capital gain/\$3,000 total net precontribution gain).

(v) The partnership must increase the adjusted tax basis of the property contributed by A by \$3,000. All property contributed by A is eligible property. Properties A1, A2, and A3 have the same character and are grouped into a single group for purposes of allocating this basis increase. Property A4 is in a separate character group.

(vi) \$2,000 of the basis increase must be allocated to long-term, foreign-source capital assets because \$2,000 of the gain recognized by A was long-term, foreign-source capital gain. The adjusted tax basis of Property A4 is therefore increased from \$4,000 to \$6,000. \$1,000 of the increase must be allocated to Properties A1 and A2 because \$1,000 of the gain recognized by A is long-term, U.S.-source capital gain. No basis increase is allocated to Property A3 because its fair market value is less than its adjusted tax basis. The \$1,000 basis increase is allocated between Properties A1 and A2 based on the unrealized appreciation in each asset before such basis adjustment. As a result, the adjusted tax basis of Property A1 is increased by \$167 (\$1,000 x \$500/\$3,000) and the adjusted tax basis of Property A2 is increased by \$833 (\$1,000 x \$2,500/\$3,000).

§ 1.737-4 Anti-abuse rule.

(a) *In general.* The rules of section 737 and §§ 1.737-1, 1.737-2, and 1.737-3 must be applied in a manner consistent with the purpose of section 737.

Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 737, the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 737. Whether a tax result is inconsistent with the purpose of section 737 must be determined based on all the facts and circumstances. See § 1.704-4(f) for an anti-abuse rule and examples in the

context of section 704(c)(1)(B). The anti-abuse rule and examples under section 704(c)(1)(B) and § 1.704-4(f) are relevant to section 737 and §§ 1.737-1, 1.737-2, and 1.737-3 to the extent that the net precontribution gain for purposes of section 737 is determined by reference to section 704(c)(1)(B).

(b) *Examples.* The following examples illustrate the rules of this section. The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 737, and all partners are unrelated.

Example 1. Increase in distributee partner's basis by temporary contribution; results inconsistent with the purpose of section 737. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A1, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$1,000. B contributes Property B, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$10,000. C contributes \$10,000 cash.

(ii) On January 1, 1999, pursuant to a plan a principal purpose of which is to avoid gain under section 737, A transfers to the partnership Property A2, nondepreciable real property with a fair market value and adjusted tax basis of \$9,000. A treats the transfer as a contribution to the partnership pursuant to section 721 and increases the adjusted tax basis of A's partnership interest from \$1,000 to \$10,000. On January 1, 1999, the partnership agreement is amended and all other necessary steps are taken so that substantially all of the economic risks and benefits of Property A2 are retained by A. On February 1, 1999, Property B is distributed to A in a current distribution. If the contribution of Property A2 is treated as a contribution to the partnership for purposes of section 737, there is no excess distribution because the fair market value of distributed Property B (\$10,000) does not exceed the adjusted tax basis of A's interest in the partnership (\$10,000), and therefore section 737 does not apply. A's adjusted tax basis in distributed Property B is \$10,000 under section 732(a)(1) and the adjusted tax basis of A's partnership interest is reduced to zero under section 733.

(iii) On March 1, 2000, A receives Property A2 from the partnership in complete liquidation of A's interest in the partnership. A recognizes no gain on the distribution of Property A2 because the property was

previously contributed property. See § 1.737-2(d).

(iv) Although A has treated the transfer of Property A2 as a contribution to the partnership that increased the adjusted tax basis of A's interest in the partnership, it would be inconsistent with the purpose of section 737 to recognize the transfer as a contribution to the partnership. Section 737 requires recognition of gain when the value of distributed property exceeds the distributee partner's adjusted tax basis in the partnership interest. Section 737 assumes that any contribution or other transaction that affects a partner's adjusted tax basis in the partnership interest is a contribution or transaction in substance and is not engaged in with a principal purpose of avoiding recognition of gain under section 737. Because the transfer of Property A2 to the partnership was not a contribution in substance and was made with a principal purpose of avoiding recognition of gain under section 737, the Commissioner can disregard the contribution of Property A2 for this purpose. As a result, A recognizes gain of \$9,000 under section 737 on the receipt of Property B, an amount equal to the lesser of the excess distribution of \$9,000 (\$10,000 fair market value of distributed Property B less the \$1,000 adjusted tax basis of A's partnership interest, determined without regard to the transitory contribution of Property A2) or A's net precontribution gain of \$9,000 on Property A1.

Example 2. Increase in distributee partner's basis; section 752 liability shift; results consistent with the purpose of section 737. (i) On January 1, 1995, A and B form general partnership AB as equal partners. A contributes Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$1,000. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$10,000. The partnership also borrows \$10,000 on a recourse basis and purchases Property C. The \$10,000 liability is allocated equally between A and B under section 752, thereby increasing the adjusted tax basis in A's partnership interest to \$6,000.

(ii) On December 31, 1998, the partners agree that A is to receive Property B in a current distribution. If A were to receive Property B at that time, A would recognize \$4,000 of gain under section 737, an amount equal to the lesser of the excess distribution of \$4,000 (\$10,000 fair market value of Property B less \$6,000 adjusted tax basis in A's partnership interest) or A's net precontribution gain of \$9,000 (\$10,000 fair market value of Property A less \$1,000 adjusted tax basis of Property A).

(iii) With a principal purpose of avoiding such gain, A and B agree that A will be solely liable for the repayment of the \$10,000 partnership liability and take the steps necessary so that the entire amount of the liability is allocated to A under section 752. The adjusted tax basis in A's partnership interest is thereby increased from \$6,000 to \$11,000 to reflect A's share of the \$5,000 of liability previously allocated to B. As a result of this increase in A's adjusted tax basis, there is no excess distribution because the

fair market value of distributed Property B (\$10,000) is less than the adjusted tax basis of A's partnership interest. Recognizing A's increased adjusted tax basis as a result of the shift in liabilities is consistent with the purpose of section 737 and this section. Section 737 requires recognition of gain only when the value of the distributed property exceeds the distributee partner's adjusted tax basis in the partnership interest. The \$10,000 recourse liability is a bona fide liability of the partnership that was undertaken for a substantial business purpose and A's and B's agreement that A will assume responsibility for repayment of that debt has substance. Therefore, the increase in A's adjusted tax basis in A's interest in the partnership due to the shift in partnership liabilities under section 752 is respected, and A recognizes no gain under section 737.

§ 1.737-5 Effective date.

Sections 1.737-1, 1.737-2, 1.737-3, and 1.737-4 apply to distributions by a partnership to a partner on or after January 9, 1995.

Dated: December 13, 1995.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved:

Leslie Samuels,

Assistant Secretary of the Treasury.

[FR Doc. 95-30870 Filed 12-22-95; 8:45 am]

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26 CFR Parts 1 and 602

[TD 8638]

RIN 1545-AT44

Certain Transfers of Domestic Stock or Securities by U.S. Persons to Foreign Corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: These temporary regulations provide the public with guidance necessary to comply with the Tax Reform Act of 1984. These regulations amend the Income Tax Regulations with respect to certain transfers of stock or securities of domestic corporations by United States persons to foreign corporations pursuant to the corporate organization, reorganization, or liquidation provisions of the Internal Revenue Code. This Treasury decision also removes certain of the existing temporary regulations regarding transfers by U.S. persons of stock or securities of both domestic and foreign corporations. This action is necessary to update the existing temporary regulations and to reflect certain of the changes announced by Notice 87-85 (1987-2 C.B. 395) (with respect to

transfers of both domestic and foreign stock or securities) and by Notice 94-46 (1994-1 C.B. 356) (with respect to transfers of stock or securities of a domestic corporation). The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the Federal Register. When finalized, the regulations under section 367(a) relating to the transfer of stock or securities will integrate the regulations herein with the 1991 proposed regulations relating to transfers of stock or securities (see Proposed Rule §§ 1.367(a)-3 and 1.367(a)-8, published at 56 FR 41993, August 26, 1991).

EFFECTIVE DATE: April 17, 1994. For further information, see the Applicability and Effective Dates section under **SUPPLEMENTARY INFORMATION.**

FOR FURTHER INFORMATION CONTACT: Philip L. Tretiak at (202) 622-3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Applicability and Effective Dates

These regulations are generally applicable to transfers occurring after April 17, 1994, the effective date of Notice 94-46. However, the active trade or business requirement (described in § 1.367(a)-3T(c)(1)(iii) of the temporary regulations herein), which was not contained in Notice 94-46, is effective for transfers occurring January 25, 1996. Moreover, these regulations remove as "deadwood" paragraphs (c)(1) through (c)(4), (d), (e), (f), (g)(1)(iii) and (h)(1) of § 1.367(a)-3T of the existing temporary regulations with respect to transfers occurring after December 16, 1987, the effective date of Notice 87-85.

Paperwork Reduction Act

These regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in these regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545-1478. Responses to this collection of information are required in order for U.S. shareholders that transfer stock or securities in section 367(a) exchanges to qualify for an exception to the general rule of taxation under section 367(a)(1).

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information

unless the collection of information displays a valid control number.

For further information concerning this collection of information, and where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-referencing notice of proposed rulemaking published in the Proposed Rules section of this issue of the Federal Register. Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On May 16, 1986, temporary and proposed regulations under sections 367(a) and (d) and section 6038B were published in the Federal Register (51 FR 17936). These regulations were published to provide the public with guidance necessary to comply with changes made to the Internal Revenue Code by the Tax Reform Act of 1984. Included in the 1986 temporary regulations was § 1.367(a)-3T, concerning transfers of stock or securities of domestic or foreign corporations by U.S. persons to foreign corporations. Subsequently, the IRS and the Treasury Department issued Notice 87-85 (1987-2 C.B. 395), which set forth substantial changes to be made to § 1.367(a)-3T, effective with respect to transfers occurring after December 16, 1987. A further notice of proposed rulemaking, containing rules under section 367(a), as well as under section 367(b), was published in the Federal Register on August 26, 1991 (56 FR 41993). The 1991 proposed section 367(a) regulations were generally based upon the positions announced in Notice 87-85, but the regulations made certain modifications to Notice 87-85, particularly with respect to transfers of stock or securities of foreign corporations.

Most recently, the IRS and the Treasury Department issued Notice 94-46 (1994-1 C.B. 356), announcing modifications to the positions set forth in Notice 87-85 (and the 1991 proposed regulations) with respect to transfers of stock or securities of domestic corporations occurring after April 17, 1994. The temporary regulations set forth herein generally incorporate the modifications announced in Notice 94-46. The notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the Federal